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Revocation of S Corp Election During Bankruptcy Upheld

By: Elliot Pisem and David E. Kahen

Approximately one year ago, we discussed in this column a decision by the Bankruptcy Court for the District of Delaware that overturned an election made by an S corporation, not a debtor in the Bankruptcy Court, to revoke its status as such.[1]

The desired effect of the election was to convert a subsidiary of the S corporation, which was a debtor in the Bankruptcy Court, from a "qualified subchapter S subsidiary" (or "QSUB"), disregarded for federal tax purposes as an entity separate from the non-debtor S corporation, to a C corporation separately subject to federal corporate income tax. The Bankruptcy Court considered that prospective loss of non-taxable disregarded entity tax status to be an unapproved transfer of property by the bankruptcy estate of the debtor and overturned the election.

In a recent, carefully reasoned analysis by the Court of Appeals for the Third Circuit, the Bankruptcy Court decision has now been reversed, sustaining the right of the S corporation and its shareholder to revoke the parent entity's S election.[2]

Background

Don Barden ("Barden") was the sole shareholder and chief executive officer of Barden Development, Inc. ("BDI"), an Indiana corporation that had elected to be treated as an S corporation for federal income tax purposes. BDI, because of its status as an S corporation, was not subject to federal income tax at the corporate level, and its income and losses passed through to its sole shareholder.

In 2005 BDI acquired the stock of Majestic Star Casino II, Inc. ("MSC II"), a Delaware corporation that owned and operated a casino and hotel in Gary, Indiana. BDI elected to treat MSC II as a QSUB for federal tax purposes. Consequently MSC II was not treated as a separate entity for federal tax purposes and its income and deductions were treated as income and deductions of BDI.

On November 23, 2009 (the "Petition Date"), MSC II and certain affiliated entities (collectively the "Debtors") filed for bankruptcy, and their Chapter 11 cases were jointly administered. Barden and BDI did not file bankruptcy petitions. After the Petition Date, Barden filed papers with the IRS revoking BDI's status as an S corporation effective January 1, 2010.

Because only a corporation wholly owned by an S corporation may qualify as a QSUB, the termination of BDI's status as an S corporation terminated the QSUB status of MSC II effective December 31, 2009 (the "Revocation"). MSC II thus became taxable as a C corporation and responsible for filing its own corporate tax returns and paying any income tax due by reason of its operations. Neither Barden nor BDI sought authorization from the Debtors or the Bankruptcy Court for the revocation of BDI's S corporation status.

The Debtors alleged that, as a result of the Revocation, MSC II was required to pay approximately $2.26 million of tax to Indiana that would not otherwise have been payable. However, at least as of the due date for the corporate tax payments for calendar year 2010, the Debtors had not paid any federal income taxes as a result of the Revocation.

In December 2010 the Debtors obtained permission from the Bankruptcy Court to convert MSC II from a Delaware corporation to a Delaware limited liability company. That conversion was effected on November 28, 2011. As of December 1, 2011, and pursuant to a plan of reorganization confirmed by the Bankruptcy Court, membership interests representing all the equity interests in MSC II were issued to certain creditors, and MSC II and the other Debtors emerged from bankruptcy on the same date.

The opinion of the Court of Appeals noted that, because QSUB status cannot be maintained except by a corporation the stock of which is wholly owned by another corporation, the QSUB status of MSC II would have terminated by reason of the above-described transactions by the time of completion of the plan of reorganization, even if the S status of BDI had never been revoked.

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The Debtors filed an adversary complaint with Bankruptcy Court on December 31, 2010, asserting that the Revocation caused an unlawful post-petition transfer of MSC II's property. They sought a recovery of that alleged property in the form of an order to direct the IRS and the Indiana Department of Revenue to restore the status of BDI as an S corporation and that of MSC II as a QSUB effective January 1, 2010.

The IRS, Barden, and BDI sought dismissal of the complaint on the basis of various arguments, including that: (i) the Debtors' complaints were not yet ripe because, at the time of filing, the Debtors had neither paid any corporate income tax nor filed any corporate tax returns; (ii) because a QSUB is disregarded for federal tax purposes, it has no cognizable property interest in that status; and (iii) even if MSC II's QSUB status were a form of property, it was dependent on elections made by its parent BDI and therefore was property of BDI (or of Barden as BDI's shareholder) rather than MSC II.

The Debtors filed a motion for summary judgment. In January, 2012, the Bankruptcy Court issued an order finding that the status of MSC II as a QSUB was the property of MSC II and belonged to its bankruptcy estate, and that the revocation by BDI of its S corporation status (which necessary terminated the QSUB status of MSC II) resulted in a transfer in violation of the automatic stay imposed under the Bankruptcy Code. The Bankruptcy Court therefore ordered that the revocation of the status of BDI as an S corporation and MSC II as a QSUB were void and of no effect. The court further ordered that BDI, Barden, the IRS, and the Indiana Department of Revenue take all action necessary to restore the status of MSC II as a QSUB, and that the Indiana Department of Revenue refund to the Debtors any taxes received as a result of the termination of QSUB status.

The results sought by the Debtors, and granted by the Bankruptcy Court on their motion for summary judgment, apparently had the potential for substantial federal tax consequences to Barden, notwithstanding that it was clear that QSUB status had been lost in any event when the Debtors' reorganization had been completed and new equity interests issued to creditors. In particular, the emergence from bankruptcy resulted in cancellation of debt ("COD") income that, the IRS alleged, amounted to $170 million.

If the Revocation were overturned, the COD income would flow through to BDI, and from BDI to its sole shareholder Barden. Taking into account that Barden and BDI were not part of the bankruptcy proceeding, that income would not be excludible from their incomes on the basis of the bankruptcy exception in Code section 108(a)(1)(A), and might therefore result in an immediate substantial tax liability for them.[3] Conversely, if the Revocation were upheld, any COD income recognized after 2010 would not pass through to Barden or trigger a tax liability to him.

On review of the Bankruptcy Court's decision, the Court of Appeals dismissed the initial argument of Barden and BDI that the Bankruptcy Court lacked jurisdiction over the IRS of the sort needed to support the relief that had been issued. The Court of Appeals ultimately vacated the Bankruptcy Court's order, however, on the basis that the court below erred in determining that the Debtors has a property interest in MSC II's tax status as a QSUB sufficient to support the relief sought by the Debtors.

Specifically, the Court of Appeals disagreed with the conclusion of the Bankruptcy Court below, and with other lower court decisions (cited in the Court of Appeals opinion) on which the Bankruptcy Court had relied, to the effect that S corporation status was "property of the debtor" for these purposes. In particular, it found the reliance in those cases on a line of authority holding that net operating loss carrybacks and carryovers ("NOLs") are property subject to protection in bankruptcy to be inappropriate.

The Court of Appeals observed that NOLs have a specific magnitude and, at least with respect to carrybacks, a readily determinable value. By contrast, an S corporation election is always subject to termination at will either by revocation approved by the shareholders or in other ways (such as the transfer of stock to a person who is not a permissible shareholder of an S corporation). Also, the benefits of an S corporation election are not subject to transfer to another person, whereas NOLs may result in greater consideration being paid in the context of a sale of the corporation.

More generally, the court concluded that since an S corporation cannot (ordinarily) control whether it maintains its status as an S corporation, that tax classification should not be viewed as a legal or equitable interest of the debtor in property for Bankruptcy Code purposes.

It was also noted that the position taken by the Bankruptcy Court (and earlier decisions on which it relied) relating to S status as being subject to preservation by court order could produce inequitable results, in the sense that shareholders of an S corporation would be required to continue to bear tax liability for income and gains of a corporate debtor (or the parent of a QSUB debtor the income of which was includible in the S corporation's income) without, typically, having any expectation of sharing in income and gains generated during the reorganization process.

The Court of Appeals found that the arguments against "property" status were at least as strong with respect to QSUB status as with respect to S corporation status, taking into account the extent to which (i) preservation of QSUB status is largely under the control of the QSUB's S corporation parent and the parent corporation's shareholders, rather than of the QSUB itself and (ii) that QSUB status is itself not assignable or otherwise transferable.

The court also viewed a QSUB's treatment as a disregarded entity for federal tax purposes as making it even more difficult to conclude that the tax status was "owned" by the QSUB. If the QSUB status was property at all, the Court of Appeals concluded that it should be viewed as property of the S corporation and not of its subsidiary.

The Court of Appeals further concluded that the Bankruptcy Court's conclusion was inconsistent with the general proposition that the filing of a bankruptcy petition is not supposed to expand or change the nature of a debtor's interest in property, but only to change the party who is considered to own that interest. Were the Bankruptcy Court's conclusion to be upheld, the court would, arguably, be placing restrictions on rights of the S corporation parent and its shareholders to take actions with respect to which the subsidiary would have no right to object prior to the bankruptcy filing—for example, to sell the QSUB's shares to any person other than another S corporation, or to sell the parent S corporation's shares to a corporation, partnership, or any other person who would not qualify as a shareholder of an S corporation.

Having concluded that the status of MSC II as a QSUB was not property of MSC II's bankruptcy estate, the Court of Appeals further found that the debtor lacked standing to challenge the revocation of that status by BDI because, in general, a person cannot claim relief on the basis of rights belonging to third parties.

The court noted that in some situations a party has been determined to have standing derived from the rights of some third party, but observed that such standing could arise only where the third party was subject to some impediment or obstacle that prevented it from pursuing its own claims. Here, the court concluded that BDI was not suffering from any such impediment and was vigorously asserting its rights. Therefore, the court concluded, MSC II lacked standing to seek to prevent the Revocation of its QSUB status.

Observations

The Court of Appeals' conclusion is welcome news from the perspective of owners of S corporations and their advisors in determining what steps may be available to mitigate potential adverse consequences from situations such as a troubled business where the prospect of cancellation of indebtedness income looms large.

It should be kept in mind that the fact pattern dealt with in Majestic Star concerned a debtor that was a QSUB, and that at least one of the arguments cited by the Court of Appeals in support of its conclusion that the Bankruptcy Court did not have the right to compel the S corporation to continue its S status would not apply were the debtor itself an S corporation. However, on a close reading, it seems more likely than not that this court would reach the same result in the latter situation as well.

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1 *Revocation of Tax Election by Non-Debtor Declared Void*, by Elliot Pisem and David E. Kahen (NYLJ April 19, 2012). See that article for discussion, not repeated here, of relevant provisions of the Internal Revenue Code ("Code") and provisions of the Bankruptcy Code.

2 *The Majestic Star Casino, LLC v. Barden Development, Inc.*, 111 AFTR 2d 2013-2028 (3rd Cir. 2013). The District Court for the District of Delaware certified the direct appeal of the Bankruptcy Court decision to the Court of Appeals pursuant to 28 U.S.C. § 158(d)(2)(A).

3 With respect to an S corporation, the applicability of certain exclusions of COD income from gross income (including the bankruptcy exception) is determined at the level of the S corporation—and BDI itself did not file a bankruptcy petition.

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